DR. KURT RICHEBÄCHER

Frankfurt
GERMANY

CURRENCIES AND CREDIT MARKETS

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"We have reached the third degree where we devote our intelligence to anticipating what average opinion expects the average opinion to be. And there are some, I believe, who practise the fourth, fifth and higher degrees."

J. M. Keynes, The General Theory of Employment
p. 156, Macmillan, London.

HIGHLIGHTS

Hopes for a global economic recovery remain doubtful. For us, the guiding consideration is whether or not there are dynamics for a robust self-feeding recovery somewhere in the world. Try as we might, we can't find such conditions anywhere.

Perversely, it is the realization that world economic prospects are deteriorating that is fuelling the recent, frenzied speculation in global bond markets. In the case of the U.S., economic sluggishness is seen as a Utopian tonic for perpetually bullish financial markets.

In the U.S., without a doubt, what we are witnessing today is a precarious and speculative financial bubble that has no precedent. It is clearly an abberation that is symptomatic of a malfunction in the real economy and the credit system.

This speculative mania is the direct cause of the Fed's frantic efforts to "pump up" the economy. Instead of stimulating the real economy, it has dangerously hyper-stimulated the financial world.

The truth is this: the longer the present speculative financial mania lasts, the greater the long-run jeopardy for financial markets and the harder it will be to restart a normal economic recovery.

The modest U.S. recovery that has occurred over the last two years owes its existence largely to one single expansionary force: the soaring budget deficit and its monetization.

Markets believe that the original debt and liquidity problems are receding. Looking at the key indicators, what we see is the exact opposite: the hard reality is that liquidity is down sharply.

Ominously, U.S. money supply figures are again collapsing. We search for the cause and point out the inevitable implications for the economy and financial markets.

The fear that money will one day rush into the real economy and trigger renewed inflation is misplaced. Any flight out of financial assets into the economy will only cause one thing: a collapse in securities prices.

The world is counting on the U.S. economy to lead a recovery. We see virtually no possibility of a sustainable recovery in the U.S. The dollar, U.S and world stock markets will be hit hard.

Global bond markets have made strong advances in recent months. We continue our recommendation to find safe harbour in the bonds of the hard currency countries.

MARKETS AND ECONOMIES: ON A TIGHTROPE

Never before has there been such a gaping, striking chasm between the conditions in world financial markets and the real economies: the former are buoyant and bouncing, the latter are faltering and tottering. Apparently, the only thing that is charming markets presently is interest rate expectations. As long as rates are perceived to be trending downwards, no matter the reason, bond markets rise and in turn hype the stock markets. Seen from this perspective, recession and weak economic recoveries are a Utopian panacea since such conditions preclude accelerating inflation and monetary tightening. As long as there's no threat of either, it's a one way bet to perpetual financial nirvana.

Markets simply only hear what they want to believe. For example, the unusually rapid decline of long-term interest rates in the U.S., Germany and Britain, has apparently been greatly reinforced by the deficit-reduction plans recently announced by their respective governments. Never mind that past experience surely gives no reason to put any trust in such pledges. But markets want action. It may well be that this latest stampede into bonds was more a bet on crowd behaviour than on the good intentions of governments. Whether or not an investor thinks the deficit reduction plans are credible or not, the belief that others might, fuels a bond rally and causes them to jump in anyway. Essentially, second-guessing becomes self-fulfilling. Speculations on the speculations of the other speculators, that's the game which nowadays determines short-term market behaviour.

Generally, it is the expectation of continued or even additional monetary ease that has fuelled the recent frenzied speculation in bonds. As usual, Wall Street is outdoing all the other markets, grasping at any straw that might conveniently serve as another buy signal. One wonders how it is that Wall Street is always so eager to discount the same recurring false promises of deficit cuts. In fact, it strikes us that of all the markets, only Wall Street zoomed on the news of the Bundesbank's recent discount rate cut. European markets were disappointed, generally remaining flat.

OVERHEATING MARKETS

In the present environment of deepening world recession and a progressive, though slow, monetary easing in Germany, interest rates remain under downward pressure worldwide, particularly in Europe. Yet, there are important differences between markets in terms of their vulnerabilities and underlying speculative excesses.

By any measure, U.S. financial markets deserve the distinction of being among the most overheated in the world. Wall Street's bullishness is dependent upon the persistence of ultra-cheap money and a record-high creation of bank reserves. As such, the primary impact is on the bond market. Bonds are the key conduit of monetary stimulation. Therefore, they are an important focus of our attention. The stock market, for its part, has just been mechanically tracking the bond market. Many commentators actually link their bullish stock market forecasts directly to the skyrocketing bank reserves — to money stimulation, in other words.

Just what is driving the rampant speculation in U.S. bonds? Two factors work together to create an enormous force: the existence of an enormous pool of low-yielding, cash-equivalent investments and deposits which is large in proportion to total financial wealth: and secondly, rate shock — the flight of investors away from the lowest interest rates in decades. An unprecedented differential exists between U.S. short- and long-term interest rates. As a consequence, huge amounts of capital are being mobilized in search of higher returns in stocks and bonds. Additionally, the large interest-rate

differential, through fuelling massive yield-curve speculation, has become the U.S. economy's main source of money and liquidity creation.

THE CONDUIT FOR ARTIFICIAL PROSPERITY

The big players arbitraging the yield curve — borrowing at low short-term rates and investing the proceeds at the much higher long-term rates — are the institutions who have access to credit at ultra-cheap money market rates. These are mainly the banks and the securities brokers. Refinancing themselves at interest costs of barely 3%, they reap easy, big profits on medium- and longer-term government bonds which yield 5-6% and more. And as interest rates fall, they reap further gains through capital appreciation on rising bond prices. The commercial banks last year added another $102 billion in bonds to their already huge holdings. Brokers last year purchased another $72 billion in mostly government bonds. Taken together with the Federal Reserve, which bought an additional $30 billion, these three buyers financed well over two-thirds of the Federal budget deficit. Their activities, no doubt, played a key role in pushing down U.S. medium- and long-term interest rates.

In this last analysis, everything is the direct cause of the Fed's frantic efforts to "pump up" the economy. Trying desperately to initiate a new credit expansion, it has slashed short-term interest rates and swamped the banking system with excess reserves. But as the real economy shows itself as being unable to respond to this medicine, the Fed's response has been simply to inject ever greater dosages of stimulus. As a result, short-term interest rates are now at 30-year lows while bank reserves have been expanding at record-high rates.

This policy mix of the Fed is showing most unusual results — in fact, already for a period of years. The ultimate objective of a monetary easing is always to restart the credit cycle. In this respect, decisively, the Fed has utterly failed. The credit engine that has propelled the U.S. economy forward at most times, remains stalled as far as the private sector is concerned. Total private credit last year rose by a mere 3.4%, nearly zero in inflation-adjusted terms and less than the level of short-term interest rates. Instead of stimulating the real economy as it wishes, the Fed has hyper-stimulated the financial world.

THE TWO ECONOMIES: REAL VERSUS FINANCIAL

There is a perverse, causal connection between the stretched over-performance of the U.S. financial markets and the prolonged under-performance of the real economy. In reality, given the enormous monetary stimulation, one is really the reverse image of the other. In principle, money always has two different outlets — one avenue into the real economy; the other one into the financial markets. If for one reason or another the normal outlets into the real economy are clogged, idle money is bottled-up in the financial assets markets, thus buoying securities prices. In explaining the current bull-run in stocks and bonds as being a "liquidity-driven" phenomenon, many market pundits convey the notion that this is a natural dynamic.

In fact, financial bull markets which take place in the face of weak economies are a regular phenomenon of the business cycle for short periods of time. A monetary easing and an accelerating money supply always make themselves felt first in the capital markets, driving up stock and bond prices. But as the real economy recovers and gathers momentum, it increasingly draws money back

into the financing of the national product. While prices for goods and services rise, those for financial assets decline. However, the current "excess liquidity" experience is clearly an abberation. It is a symptom of a malfunction in the real economy.

Economic sluggishness, a stage that rarely lasted as long as a year in previous cycles, has already stretched over several years this time. As economic weakness prolongs, so has the financial bullishness, resulting in the absurdity that U.S. stocks have become overvalued as never before. It's gone on so long that Wall Street now fervently hopes for more economic sluggishness. The last thing it wants is stronger economic growth. That would disrupt the gravy train in the bond market. Also not wanted is an economy that's too weak. That would shake confidence and derail the stock market. Is economic sluggishness the magic potion for perpetual financial bullishness? Wall Street certainly thinks so. We definitely do not.

Wall Street justifies the ever higher valuations in the stock and bond markets with one argument — low and falling inflation. It has become conventional wisdom to believe that long-term interest rates mainly reflect inflationary expectations therefore. Therefore, the thinking goes, the lower the long-term rates, the lower must be the inflation expectation. Apparently, credit quality and the supply and demand for bonds doesn't play a role; budget deficits and low saving levels aren't important.

Ultimately, market prices are always dependent on underlying supply and demand conditions. The more supply and the lower the demand, the lower the prices and vice versa. In the case of interest rates, over the long run, their level is essentially determined by the relationship between credit demand and available savings. From this perspective, given the extremely low domestic savings and the huge budget deficit, the U.S. economy is bound to face structurally high interest rates. If it weren't for extremely easy money and sharply lower private credit demand, that would already be manifest. Yet, in 1992, the savings-credit balance worsened drastically. While total credit demand — public and private — surged to $590 billion from $442 billion, total savings — personal and corporate — were well below $300 billion. Nevertheless, interest rates collapsed. How did that happen?

HOW THE FED PUMPS UP THE BOND BUBBLE

In order to create sharply lower interest rates, and to keep them down, the Fed has had to engineer a large-scale monetization of the budget deficit. What monetization means in this case is that a portion of government debt has been converted into the monetary base. The mechanics are always the same. By making heavy bond purchases on its own account, the Federal Reserve creates excess reserves. Briefly, what happens is this: When the Fed buys bonds, it must pay for them in cash just as anyone else would. It does so by simply crediting the amount to the account of the settling member bank which is held at the Federal Reserve. As a result, the cash reserves of the banking system rise in excess of a required level. This overage is the excess reserve. Since banks do not receive any interest on their reserve deposits, they are eager to redeploy this excess reserve amount into an asset that pays income — an investment or a loan. Using this mechanism, the Fed can put the banking system under constant pressure to expand its assets. That's exactly what the Fed did. Last year the banks obliged by increasing their bond holdings a further $102 billion.

As mentioned earlier, banks and securities brokers together purchased $174 billion in bonds last year. It's important to understand what happens next in the chain. Broker and bank purchases are essentially

akin; their effect on the bond market is similar. However, from a monetary point of view, there is a crucial difference: bank purchases of bonds result in the creation of new demand deposits. When a bank buys a bond it must credit somebody's account in payment. When it does so, a new demand deposit is created somewhere in the banking system. As such, there is a corresponding increase in the money supply. The bond purchase of a broker, by contrast, does not change the money supply. Brokers finance their bond purchases by using existing demand deposits which they borrow from their customers or institutions. You might say brokers create credit without creating money. In conventional words, they increase money velocity.

The essential point to realize is this: bank purchases of bonds create money. It is this process that the Fed has been using as never before to bolster the otherwise flagging money supply, finance the onerously large budget deficits, and to nurse the weak banking system back to profits.

MISCONCEPTIONS AND FALSEHOODS

When we say that the U.S. financial markets are among the most overheated in the world, we're basically alluding to the paper chase of the banks and brokers that's being fanned up by the aggressively stimulative policies of the Fed. What we are witnessing, already for more than two years, is a speculative bond bubble of unprecedented magnitude. This chase cannot continue at this frantic pace, even if monetary conditions remain favourable.

A most critical question for the markets — currencies, bonds as well as stocks — is the U.S. recovery's zest and endurance. As we've mentioned, sub-par growth is seen as the great panacea. In a sense, it's become a "tightrope" economy. It must remain weak enough to keep inflation and monetary tightening at bay, yet strong enough to improve business profits. Markets, at their rarefied valuation levels presently, are vulnerable to either scenario.

As well, markets have gullibly swallowed the comforting notion that the debt and liquidity problems that originally begot the recession are rapidly on the mend. Consumer and corporate liquidity are said to have improved dramatically. Above all, much is made of the drastic lightening of the debt burdens attributable to the sharp interest rate cuts. More than anything else, it is argued that this process of financial consolidation is laying down the foundation for sustained economic growth.

Nothing of the sort is happening, we think. Interest rate cuts have greatly helped debtors to be sure, but it should be clear that total incomes and liquidity are not being increased. What the interest rate cuts achieve is a reshuffle of incomes from creditors to debtors. No more, no less. Overall, it's a zero-sum game in which the debtors gain exactly what their creditors lose.

Desperately trying to prove that there really is a growth effect resulting from these interest rate cuts, American economists have made a discovery that nobody has ever thought of before. Net consumer spending must rise, they argue, because the not-so-rich debtors will spend the windfall that results from lower interest expense while the richer creditors who lose interest income are better able to maintain their spending. So, in other words, the net effect of this income reshuffle is higher consumer spending but at the expense of lower available savings.

Leaving aside the fact that a reduction of already low savings is the very last thing that the American

economy needs, the whole argument is seriously flawed. In determining the winners and losers in this income transfer, the first thing to realize is that the biggest winners are government and businesses, not the consumers. That has to be the case because they are the net debtors in every economy.

The big losers, contrary to widespread opinion, are the consumers. They are the nation's main creditor because of their savings surplus. In the aggregate, private households have far more financial assets than debts. Therefore, they are the one sector in the economy that is a big net earner of interest income. At the peak in 1991, personal interest income for this sector exceeded interest-rate expenses by $700 billion. This net surplus has since fallen to $655 billion. In any case, the idea that only rich people have interest income that they don't need is absurd. In the first place, truly rich people tend not to have their assets predominantly in short-term, interest-bearing investments. They are more inclined to be long-term investors and instead are significant owners of business equity. It's investors who are dependent on their capital for income — pensioners and retirees, for example — that are much more exposed to declining interest income. If income declines in their case, they are certain to spend less. In sum, forget it. Lower interest rates by themselves cannot spur spending.

THE MONETIZED BUDGET DEFICIT: WHAT STOPPED THE RECESSION

In modern times it has been accepted wisdom that monetary policy impacts the real economy mainly through one channel — through the expansion or contraction of credit. The big increases in purchasing power that are needed to catapult and sustain an economic recovery can only come from a credit expansion. But in the United States — and elsewhere — a credit expansion remains elusive. Monetary easing is proving to be utterly ineffective precisely in the capacity that it is supposed to be the most capable. The thing to see is that this situation literally excludes the possibility of self-feeding economic growth.

The modest U.S. recovery that has occurred over the last two years owes its existence largely to one single expansionary force: the soaring budget deficit and its monetization. It was this alone that prevented a deepening recession. As a function of its size and the way that it has been financed, the deficit has been both the key demand and the key liquidity source for the private sector. Therefore, if the budget deficit ceases to grow, the economy will be deprived of its stimulative effects.

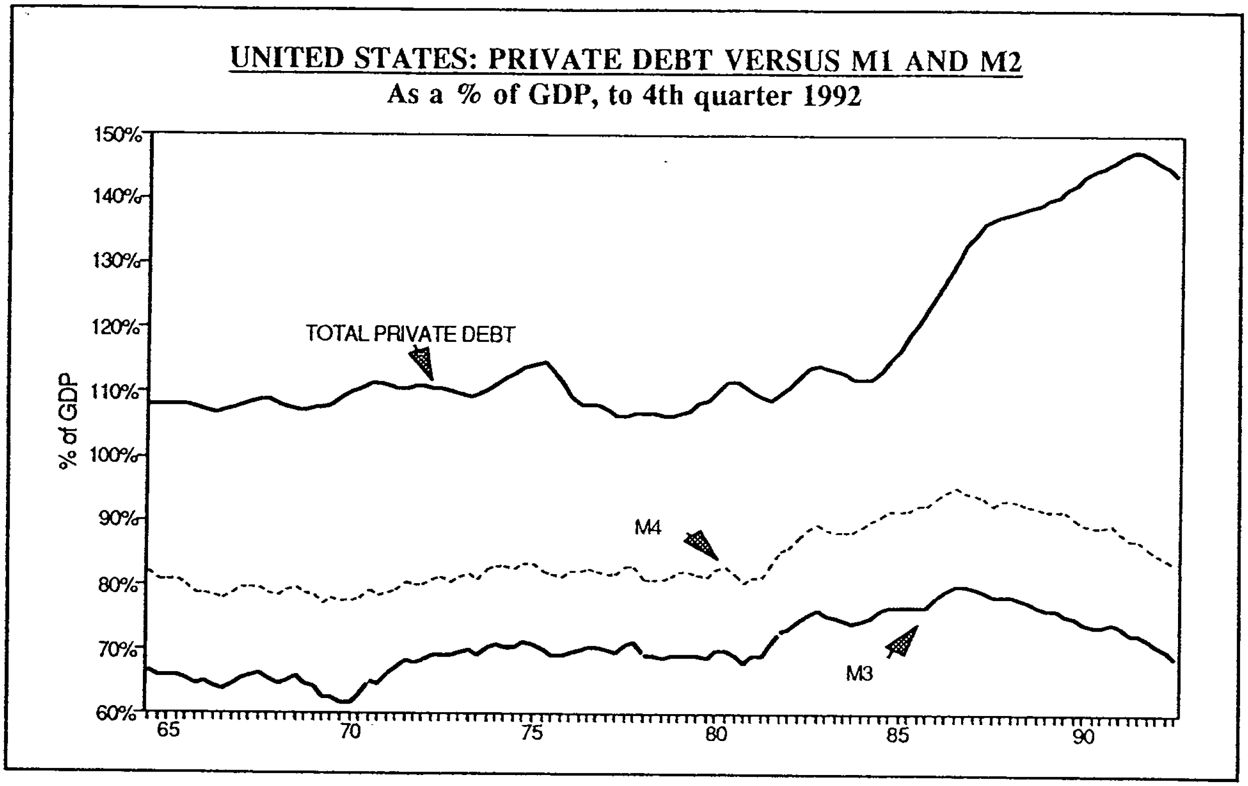
LIQUIDITY ILLUSIONS

Assessing the U.S. economic situation, our main concern is liquidity. While most reports we read indulge in enthusiastic claims that liquidity is dramatically improving, when we scrutinize the really conclusive gauges for overall liquidity we find the exact opposite — a dramatic deterioration.

What are these conclusive gauges we look at? For one, broad money. The most comprehensive measure is M4 or L. It is the broadest definition of liquid financial assets — from demand deposits to treasury bills and money market funds. During the last 12 months, this broad money aggregate has increased by a mere $63 billion. That compares dismally with overall private debt growth of $279 billion. During this same period, M3 contracted by $55 billion or 1.3%. Clearly, private debt growth exceeds private liquidity growth by far. That is definite proof that overall liquidity is worsening.

Not only is overall liquidity worsening, the immediate reality is even more ominous: recent data shows

that the shrinkage is gaining momentum. During the last three months, M2 has contracted by $25 billion and M3 by about $55 billion. Even M1, which was expanding explosively not so long ago, has abruptly peaked and flattened. This is the weakest broad money growth on record.



To get a broad and long-term perspective of the present monetary situation, we have reviewed the development of money and liquid assets relative to GDP (Gross Domestic Product) since the early 1960s. The graph above shows these relationships, depicting private debt, M4 and M3 as percentages of GDP. What's obvious is that all the broad money gauges show a steep decline relative to GDP since 1988. M4, after soaring in 1982-87 from little more than 80% of GDP to almost 95% of GDP, is almost back to its starting point. M3 displays virtually the same picture of a rapid expansion followed by an equally rapid contraction.

Private debt in relation to GDP has continued its rise unswervingly over this period, although now it is plateauing at an elevated level. There really has been no private debt liquidation. In any case, government debt is soaring. Comparing the plunging liquidity ratios with the record debt ratio, we have serious difficulty reconciling the current euphoria about dramatic improvements in liquidity taking place. If debt continues to rise relative to overall liquidity, how can there be an improvement? The so-called "liquidity-driven" bull trends in the financial markets-runs must obviously be based on something very different. As we've already shown, that "something" is entirely the product of the Fed's massive direct stimulation of the financial markets.

THE CONUNDRUM: SUDDEN MONEY DESTRUCTION

As explained, there has been a big income transfer triggered by the interest declines which serves to

liquefy the debtors at the expense of the creditors. Also, there has been considerable money creation through the heavy monetization of the budget deficit. Yet, the hard reality is that overall liquidity, properly measured by broad money, is down sharply.

What was slow money growth up until November of last year, has abruptly deteriorated into a massive money and liquidity destruction. Take M3. After hovering around $4,185 billion during the year until November 1992, it has suddenly sagged to $4,129 billion, a decline of 4% at an annual rate. That's unprecedented. More mysteriously, it's happening despite continuing monetary ease.

Many economists shrug off the recent money decline with technical explanations. They assume, comfortingly, that it largely reflects a stampede of investors from bank deposits into securities. Even Mr. Alan Greenspan, the Chairman of the Federal Reserve Board, is reassuring. In his Congress testimony he said, "*the relationship between money and the economy may be undergoing a significant transformation . . . the FOMC [Federal Open Market Committee] necessarily has given less weight to monetary aggregates*".

As we have often explained, these shifts of funds by investors from deposits into securities or mutual funds do not cause any money destruction. What these shifts do are actually two things: firstly, inflate transaction money, M1; and secondly, inflate securities prices. But since M1 is a component of broad money, both M2 and M3 remain unchanged.

Mainly two things could contract the money supply: either repayments of bank debt or bank sales of bonds. A case in point is when corporations repay existing bank loans from the proceeds of bond and equity issues. But, net corporate securities issues have been running at rather normal levels recently and are relatively unchanged against last year. Therefore, this cannot be the main cause of the recent money contraction. A key point to recognize is that businesses are investing less than their cash flow. That implies economic weakness. In that sense, the weak money data is reflecting this trend correctly.

MONEY VELOCITY: A SHIBBOLETH THAT EXPLAINS NOTHING

Mr. Greenspan and many lesser notorieties like to explain the apparent unlinking of the connection between broader money — M2, M3 and M4 — and GDP with the concept of rising money velocity, implying that money simply moves faster. It's a shibboleth that really explains nothing. As a rule, money and credit over time have tended to grow in lock-step with GDP. There have been important exceptions to this relationship, but in each case there was always a particular cause.

During the 1980s, especially so in the earlier half, broad money and credit expansion greatly exceeded GDP growth. That was due to the fact that a large part of the newly created money went into the financial markets. Instead of boosting GDP and the prices of goods and services, the excess money buoyed asset prices — stocks, bonds, and real estate. Most experts interpreted it as a harmless, if not healthy, decline in money velocity. Right at the outset, we interpreted it as a forewarning of a runaway asset price inflation, something that reminded us of the 1920s.

Now, we have the opposite phenomenon: money is growing much less than nominal GDP. Is there any rational explanation apart from the velocity nonsense? It could be that the excess broad money that was created between 1982-87 is now being absorbed. Cash balances that were inflated earlier may be

drawn down. But as the previous chart shows, the former money bubble has been virtually all soaked up — the ratio of M3 and M2 to GDP is almost back down to the levels that prevailed during the 1970s.

In one respect, the rise in money velocity which supposedly rescued the U.S. economy from the strangling effects of weak money growth, is not so mysterious. There was an underlying deeper cause: the export boom of 1987-90. During that time, rising exports accounted for almost 50% of U.S. GDP growth. Following that, in 1991-92, stimulative fiscal policy in turn pulled the cart. But what's going to pull the U.S. economy in future if a money and credit expansion doesn't?

To be able to judge the implications of such a sudden, severe money contraction, one has to find its exact cause. Unfortunately, the necessary data to do that isn't available yet. For now, we can only guess. One temporary cause could be high tax payments. However, the regular seasonal adjustments of the money supply should smooth out this effect. Another more sinister reason would be lower bond purchases by the banking system. If that happens, it will have disastrous consequences both for the economy and financial markets because, as we've shown, there isn't an alternative liquidity source. To be sure, it's an extremely precarious source of liquidity that theoretically could stop flowing overnight.

THE BULLISH MARKETS ARE A MONEY TRAP

Back to the key question: What are the possible and probable implications of this monetary imbroglio, firstly, for the real economy, and secondly, for the financial markets?

As for the first part of the question, we have not the slightest doubt: monetary policy remains totally ineffective in stimulating the real economy. To many observers, the strong growth of the monetary base (central bank money & currency in circulation, as partly explained earlier) indicates a highly expansionary monetary policy which is bound to be followed by an inflationary overheating. Yes, the high-powered monetary base and M1 have virtually exploded, but so far, this reflects nothing other than an increasing use of money (demand deposits) for financial speculation.

There is a widespread fear that the flood of money which is presently bloating financial assets, will one day rush into the real economy. The worry is that it will inflate the prices of goods and services when it does. Rest assured, this will never happen. It's technically impossible. The money has already been created; it has already been spent. Any attempted flight out of financial assets into the real economy will cause only one thing: a collapse in the prices of financial assets. To get out of financial assets — stocks or bonds — the seller must find another buyer who is prepared to give up money in exchange. The only thing to be moved is prices, not capital. Instead of promoting a recovery, such a flight would result in a savage asset price deflation and a depression for the real economy. Financial bubbles are never a source of liquidity. Eventually, they are always the cause of illiquidity.

Keeping the above in mind, the truth is this: the longer the present speculative financial mania lasts, the greater the jeopardy for financial markets over the longer run, and the harder it will be to restart a normal economic recovery. Increasingly, the Fed is losing control.

What about the financial markets? How long can this speculative bubble play out? The important

question is what might possibly shake the market's complacency. If nothing else, at best, the frenzied speculation will just exhaust itself eventually. Banks and brokers, in particular, cannot continue to make their huge bond purchases indefinitely.

At worst, the bursting of the bubble could be triggered by a sharp disappointment over the continuing recovery. Nobody wants an economy that's too strong nor would the markets like a renewed downturn. It would deflate corporate profits and trigger a whole myriad of other troubles. Uppermost, it would destroy the comforting perception of an economy that is on the mend. The first casualty would be the dollar. A generally deteriorating market climate would soon hurt the stock market, too.

Another possibility to be considered, if only for argument's sake, is a much stronger than expected recovery. While such a development would initially buoy the dollar and the stock market, it would send bond holders, above all the leveraged banks and brokers, to the exit. The bond market would crash and long-term interest rates would rise precipitously thus quickly choking off any recovery. Either way, the runaway bubble will exact its price in the end.

INTERNATIONAL DYNAMICS

It goes without saying that a relapse of the U.S. economy would have far-reaching implications for the world economy. In Europe and elsewhere, hopes for an impending economic recovery hinge crucially on the expectation that the U.S. economy will take up its traditional role as locomotive for the world business cycle and that the U.S. dollar will appreciate. These are misplaced hopes. We can only repeat our often-expressed warning: The U.S. is not experiencing a normal business cycle upswing. It is something fundamentally different.

Economists everywhere — in Japan, England, the U.S., Canada . . .etc. — are eagerly searching for the green shoots of an imminent recovery. The false assumption underlying this search is that any upturn, no matter how shallow, once started, must essentially gather momentum just as has been the regular experience of all post-war business cycles. However, this rule has had its exceptions. In the 1930s, too, there were many false starts. For us, the guiding consideration is whether or not the dynamics for a self-feeding, robust recovery are falling in place in any country right now. Our answer: nowhere — not in the United States, not in Europe, not in Japan.

When looking for precursors of growth, we focus on credit, money, and investment spending. Sharp fluctuations in capital spending financed by credit are the prime mover of economic upturns and downturns. As investment booms, it feeds into rising employment and consumer expenditures. As investment shrinks, it depresses employment and incomes.

In the United States, Britain, Australia, Canada and other countries, where recessions started about three years ago, investment spending remains subdued while spending on plant and equipment in Europe and even in Japan is plunging. Most obviously, in Europe as in Japan, the unfolding recession is mainly a reflection of a sharp slowdown in investment, consumption following suit.

The differences in the investment performances are truly striking. Superficially, the U.S. economy seems to be in better shape in this regard. Its downturn in investment spending was only mild. Now it's rising again despite the economy's slow growth. *"America the super-fit,"* wrote the London

Economist recently, pointing to strong computer investment and productivity growth.

In reality, this relatively superior U.S. investment performance is more optical than real. America's long-run investment ratio is among the lowest in the world. In fact, the ratio has fallen to a record-low. Japan and Germany, by contrast, experienced extraordinary investment booms. High investment ratios tend to provide superior dynamics to an economy not only on the upside but also on the downside. Since investment is the most volatile GDP component, the high-investment economies are therefore subject to greater cyclical gyrations than the low-investment economies.

GERMANY AND EUROPE

For Europe, all eyes remain on Germany. The west German economy has slowed more sharply than expected earlier; the fading demand boost from German unification is compounded by dropping foreign demand. Economic weakness is centred in the cyclical industries, particularly automobiles, machinery, and steel. So far, however, a briskly expanding service sector has prevented a fall in real GDP (not counting the 6% growth-rate contribution of east Germany.)

Germany's investment-led economic downturn is sure to continue. Undoubtedly, there has been over-investment over the past few years. The increasingly distorted exchange rates during the late 1980s generated a large structural export surplus. Now, this surplus has nearly disappeared. As well, the unification boom and the lead-up to Europe 1992 played a stimulating role. Gross policy mistakes have made Gèrman unification much more costly than anticipated. Escalating wages and inflation furthermore forced the Bundesbank to keep interest rates high even in the face of weakening economy.

Germany faces enormous challenges, but so do policymakers all around the world. For Germany, important policy targets have been achieved: above all, modest wage rises, and sharply lower money and credit growth. Still, we expect that the Bundesbank will move cautiously. German short-term interest rates are sure to stay well above U.S. rates. The main problem is the government and its fiscal policy — the budget deficit remains high. But in this respect, Germany has much company. Budget deficits are rising around the globe and some major countries have much more serious imbalances.

Despite the problems, Germany retains some strong positives compared to other countries — a high savings ratio, virtually no debt problems, an ultra-strong banking system, a serious housing shortage guaranteeing a long-term building boom, and high investment commitments in east Germany which supports demand for investment goods. For Germany, what we worry about more are the international conditions and not so much the internal factors.

CONCLUSIONS

The first thing that should shape investment thinking is that there's no economic recovery worth its name in sight. Everywhere, cyclical weakness is being compounded by structural maladjustments that will take years to heal.

The Anglo-Saxon countries are trapped in overconsumption and overindebtedness. In contrast, Germany and Japan are struggling with an overexpanded industrial base. In the case of Germany, financial and other adjustment problems resulting from unification complicate the picture. Japan's

situation is much grimmer. Its extreme investment and financial excesses weigh very heavy on its economy and financial system.

We don't share the optimism that's emerged on Japan lately. The roaring investment boom that occurred in Japan since 1987 was based on soaring profits from financial speculation thus serving to mask an underlying deterioration in operating earnings. From what we see, lots of adjustment is still ahead for Japan's economy and financial markets.

Looking at U.S. financial markets, a historical perspective clearly reveals them to be more overheated than ever before. We have explained our misgivings over the bond bubble. A huge budget deficit, mostly financed by speculation rather than the investment of savings, is the recipe for financial disaster. Any sharp setback in the bond market will prick the stock market bubble and derail the economy.

We have been bullish on European hard currency bonds for some time. After considerable gains, these bull markets still have some leeway but some consolidation is due. French bonds are the most attractive. The high money market rates (11%) in France which have been required to defend the franc are unsustainable. When these rates drop, French bonds should do well. However, because of the currency risk, futures are preferable to cash bonds.

Both the French franc and the U.S. dollar are headed for major tests in the currency markets.

SPECIAL NOTE!

Dr. Kurt Richebächer will be speaking at the upcoming Dinner Program of the Committee for Monetary Research & Education (CMRE) on Thursday, April 22, 1993. Registration deadline is April 16, 1993. For information call CMRE's office at (203) 661-2533.

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Publisher and Editor, *Currencies and Credit Markets*: Dr. Kurt Richebächer
Mendelssohn Strasse 51, D-6000 Frankfurt 1, GERMANY. TELEPHONE: 49-69-746908 FAX: 49-69-752583

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